United States Court of Appeals

for the Second Circuit

BRIEF FOR APPELLEE

76-7178

IN THE

United States Court of Appeals

FOR THE SECOND CIRCUIT

B

FRANKLIN SAVINGS BANK OF NEW YORK,

Plaintiff-Appellee,

P/S

—*against*—

GUSTAVE L. LEVY, *et al.*,

Defendants-Appellants.

BRIEF FOR APPELLEE

THACHER, PROFFITT & WOOD
40 Wall Street
New York, New York 10005
(212) 483-5800
Attorneys for Plaintiff-Appellee

ROBERT S. STITT,
GEORGE W. TALIAFERRO, JR.,
RAYMOND L. VANDENBERG,
Of Counsel.

TABLE OF CONTENTS

Cases Cited

PAGE

Statute Cited

Other Authorities Cited

IN THE

United States Court of Appeals

FOR THE SECOND CIRCUIT

FRANKLIN SAVINGS BANK OF NEW YORK,

Plaintiff-Appellee,

—*against*—

GUSTAVE L. LEVY, *et al.*,

Defendants-Appellants.

BRIEF FOR APPELLEE

Preliminary Statement

The defendants, Goldman, Sachs & Co. and its general partners ("Goldman, Sachs"), have appealed from a judgment entered against them in favor of the Franklin Savings Bank of New York ("Franklin") by the United States District Court for the Southern District of New York (Metzner, D.J.) after trial without jury. The action was brought under the Securities Act of 1933 and the Securities Exchange Act of 1934. The District Court's 24-page opinion was filed December 29, 1975 and is reported at 406 F.Supp. 40 (1453a).

The defendants have also appealed from the District Court's denial of their motion, pursuant to Rules 52(b)

and 59(a) to amend its findings and direct judgment in their favor, or alternatively, to grant a new trial.

Questions Presented for Review

1. Did the District Court err in finding jurisdiction under the Securities Act of 1933?

2. Did the District Court err in finding jurisdiction under the Securities Exchange Act of 1934?

3. With respect to the 1933 Act, was the District Court's finding that Goldman, Sachs sold Penn Central commercial paper to Franklin without disclosing material information supported by substantial evidence?

4. Did the District Court properly impose liability on Goldman, Sachs under Section 10(b) of the Securities Act of 1934?

Proceedings Below

This Penn Central commercial paper case was tried before Judge Metzner in June 1975. The trial, including closing arguments, required nine days. Franklin called its president, Harry H. Bock and, for the purpose of identifying documents, Thomas P. Asay of the Penn Central Transportation Company. Goldman, Sachs called Gustave L. Levy, its senior partner; Robert G. Wilson, the partner in charge of its commercial paper department; George M. Van Cleave, a vice president who is second to Wilson in charge of the commercial paper department; Jack A. Vogel, vice president in charge of the credit division of the commercial paper department; Raymond C. Lepley, an officer of Penn Central Transportation Company who was in charge of its commercial paper relationships with Goldman, Sachs; George E. Doty, a senior partner of Goldman, Sachs and John A. Sullivan, an officer of the Manufacturers Hanover Trust Company.

The plaintiff offered deposition testimony of Mr. Levy, Mr. Wilson, Mr. Van Cleave, Mr. Vogel, John L. Wein-

berg, a senior partner of Goldman, Sachs with overall responsibility for supervision of the commercial paper department, and of seven other officers or employees in Goldman, Sachs' commercial paper department—Paul S. Weiss, Matthew Tolan, Roger M. Lynch, Michael L. Evans, Robert L. Hoffman, Robert H. Kaufman and Michael E. Bruno II. Plaintiff also designated testimony given by Wilson, Vogel and Levy in the prior trial of *Welch Foods, Inc.* v. *Goldman, Sachs & Co.*, 398 F.Supp. 1393 (S.D.N.Y. 1974) and by Levy and Wilson before the United States Securities and Exchange Commission (*In the Matter of Penn Central Company, et al*—File No. HO-482).

Franklin offered approximately 90 documents which, for the most part, were internal memoranda and other records produced by Goldman, Sachs during the course of pre-trial discovery. Hundreds of documents were offered by the defendants.

After filing of the District Court's opinion on December 29, 1975 and the entry of judgment shortly thereafter, the defendants moved the District Court to amend its findings and direct judgment in their favor or, alternatively, to grant a new trial. The grounds for this motion were (1) that the District Court's finding of jurisdiction under the 1934 Act was predicated upon incompetent proof concerning the National Credit Office (NCO) (Defendants' memorandum dated January 23, 1976, Point I); (2) that the District Court's finding that Goldman, Sachs "just did not have faith in this paper anymore and was lightening its load and reducing its exposure" was not supported by the record and that the court improperly rejected Goldman, Sachs' technical explanations for its inventory decisions (Defendants' memorandum pp. 12, 21, Opinion pp. 18-19; 1475a, 1484a, 1459a)* and (3) that the District Court's decision would have been different if it had received further proof with regard to three matters: (a)

* For the most part, citations are to trial testimony, trial exhibits and depositions; appendix citations follow in sequence.

Brown Brothers Harriman's removal of Penn Central's paper from its approved list on February 5, 1970; (b) other "buy-back" transactions between Goldman, Sachs and commercial paper issuers and (c) the handling of Mr. Annenberg's Penn Central stock and a block trade of Penn Central common stock on May 27, 1970 some two months after Franklin's purchase. (Defendants' memorandum Point II).

The District Court reviewed the record and denied the defendants' motion by memorandum decision entered March 8, 1976 (1544a). Defendants filed their notice of appeal on April 5, 1976 (1a 4).

Statement of Facts

The following facts are supported by substantial evidence:

1. Franklin is a mutual savings bank, organized and existing under the Banking Law of New York State, with a principal office at Eighth Avenue and 42nd Street, New York City (Pre-trial order p. 113, Stipulated facts, par. 1; 1448a).

2. Goldman, Sachs is a partnership engaged in the business of investment banking, underwriting and dealing in securities with a principal office at 55 Broad Street, New York City (Stipulated facts pars. 2 and 3; 1448-49a). Goldman, Sachs is registered with the Securities and Exchange Commission as a broker-dealer and is a member of the New York Stock Exchange, other national securities exchanges and the National Association of Securities Dealers, Inc. (Stipulated facts par. 3; 1449a). It has achieved a reputation as one of the leaders in the securities business, particularly in the area of commercial paper in which it held itself out as the oldest and largest

dealer (Wilson 1134; Exhibit F-32; Bock 172; Opinion p. 3; 1136a, 1312a, 172a, 1454a).

3. Penn Central Transportation Company ("Penn Central") is a Pennsylvania corporation which owns and operates the Penn Central railroad system. The principal office of Penn Central is in Philadelphia (Stipulated facts par. 4; 1449a). Penn Central began issuing commercial paper in the summer of 1968 and continued to issue commercial paper until sometime in 1970 (Stipulated facts par 5; 1449a).

4. Commercial paper is an unsecured promissory note issued by a corporation on a short-term basis to take care of cash flow problems of short-term duration (Bock 91-92, Stipulated facts par. 5, Tr. 290; 91-92a, 1449a, 290a). It is self-liquidating in concept; the money is used, for example, to buy raw materials and fashion them into finished products, thereby generating the cash required to pay off the note (Bock 92; 92a). It has always been considered a very low risk investment on the theory that its self-liquidating feature insures repayment upon maturity (Bock 92; Exhibit F-32; 92a, 1312a).*

5. Goldman, Sachs was the exclusive dealer for Penn Central (Stipulated facts par. 6, Van Cleave 501; 1449a, 502a). As dealer Goldman, Sachs purchased the notes directly from Penn Central for resale as principal and held the notes in inventory just as a retailer holds stock-in-trade in inventory (Opinion pp. 3-4; Stipulated facts, par. 7; 14[illegible]a, 1449a). In doing so, Goldman, Sachs was assuming a market risk with respect to such papers (Doty 599-600; Opinion pp. 17-20; 600-601a, 1458-59a).

---

* During the congressional hearings on the 1933 Act, commercial paper was described as having "a record of safety only second to government bonds. . . ." *Sanders* v. *John A. Nuveen & Co., Inc.*, 463 F.2d 1075, 1079 n. 12, *cert.* denied 409 U.S. 1009 (1972).

6. In June 1968 New York enacted a statute [N.Y. Banking Law §235(12-a) (McKinney 1971)] which allows savings banks to invest in commercial paper (Bock 94-95; Opinion p. 4; 94-95a, 1454a).

a) The purpose of the statute was to widen the investment opportunities available to these banks to include low risk and higher interest-paying securities (Opinion p. 4; 1454a). To qualify for purchase by a savings bank, the paper had to receive the highest rating ("Prime") of an independent rating service designated by the State Banking Board (Exhibit F-81; Bock 94-95; Opinion p. 4; 1350a, 94-95a, 1454a). NCO, a subsidiary of Dun & Bradstreet, Inc., was so designated (Bock 95; Opinion p. 4; 95a, 1454a).

7. Immediately after the adoption of this law, Goldman, Sachs wrote Franklin requesting the opportunity to make a presentation of the services it could render Franklin in the purchase of commercial paper (Exhibit F-81; Bock 95-96; Opinion p. 4; 1350a, 95-96a, 1454a). During subsequent communications Goldman, Sachs gave Franklin a pamphlet entitled "Commercial Paper, An Attractive Short Term Investment" reviewing its long experience in commercial paper and outlining the services which it provided (F-32; Bock 95-96; 1312a, 95-96a). Bock met with representatives of Goldman, Sachs and was shown its facilities (Bock 96; Exhibits F-91 and F-92; 96a, 1353a, 1364a). It was understood that the commercial paper which Goldman, Sachs would offer Franklin would be creditworthy and of high quality (Opinion p. 22; Bock 109-10, 225-27, 266 and 282; Wilson 1134-35; Exhibit F-32; 1459-60a, 109-10a, 225-27a, 266a, 282a, 1136-37a, 1312a).

8. Franklin started purchasing commercial paper in August 1968 and from Goldman, Sachs in September 1968 (Exhibit F-82). All of its purchases over the ensuing two years were through dealers (Exhibit F-82;

Bock 99-100; 99-100a). Franklin never purchased any paper from direct issuers; it wanted the additional protection which a dealer would provide (Bock 99-100; 99-100a). This included a dealer's access to corporate information and its surveillance of the issuer's affairs (Bock 99-101, 103, 108, 225-228; Wilson 1134-35; 99-101a, 103a, 108a, 225-28a, 1136-37a).

9. In the aforementioned pamphlet delivered to Franklin, Goldman, Sachs also represented that it provided financial information and supplementary data on companies issuing notes to the investor (Exhibit F-32; Bock 103, 227; Wilson 1130; 1312a, 103a, 227a, 1132a). Such written information was mailed by Goldman, Sachs to Franklin in their subsequent course of business (Bock 103; 103a). Franklin purchased most of its commercial paper through Goldman, Sachs (Exhibit F-82; Bock 107; 107a). One reason for doing so was the written financial information which Goldman, Sachs furnished (Bock 107-8, 99-101; Wilson 1129-30; 107-8a, 99-101a, 1131-32a).

10. On March 16, 1970, Goldman, Sachs sold Penn Central commercial paper with a face value of $500,000 and a maturity date of June 26, 1970 to Franklin for a net price of $487,958.33 (Opinion pp. 4-5; Stipulated facts par. 8; 1454a, 1449a). As conceded at trial, in offering the commercial paper to Franklin, Goldman, Sachs was recommending it for purchase (Bock 120-21; Tr. 1283, 1259; Levy EBT 225-26; 120-21a, 1285a, 1261a). On June 21, 1970, ninety-seven days after the sale, Penn Central filed its reorganization petition with the United States District Court for the Eastern District of Pennsylvania (Opinion p. 5; Stipulated facts par. 9; 1454a, 1450a). The note was duly tendered but payment has never been received (Opinion p. 5; Exhibit F-89; Stipulated facts par. 10; 1454a, 1361a, 1450a). Penn Central is still in reorganization (Stipulated facts par. 9; 1450a).

11. As part of its recognized duty to disclose material information, Goldman, Sachs furnished its customers with three types of written information contained in "white", "green" and "yellow" sheets (Opinion p. 20; Van Cleave 371-72, 378-80; Vogel 719-20; Wilson 1129-30; cf. Wilson EBT 493; 1459a, 371-72a, 378-80a, 720-21a, 1131-32a). The "white" sheets are a duplication of the issuer's annual report and audited financial statement (Opinion p. 20; Van Cleave 371; 1459a, 371a). The "yellow" sheets describe the business of the issuer and highlight some of the pertinent figures found in the "white" sheets (Opinion p. 20; Van Cleave 371; 1459a, 371a). The "green" sheets contain additional credit information which may be of importance to the purchaser of the commercial paper (Opinion p. 20; Vogel pp. 719-20; Van Cleave 371; 1459a, 720-21a, 371a). Goldman, Sachs' criteria in determining if a "green" sheet should be prepared and circulated included materiality and disclosure (Opinion p. 20; Vogel 719-20; 1459a, 720-21a).

12. Since commercial paper notes are short-term and unsecured, the insurer's liquidity is "very important" (Levy 831; Bock 91-92; 832a, 91-92a). Bank lines of credit supporting an issuer's commercial paper are also important to commercial paper purchasers because they provide an additional ready source of cash to meet commercial paper maturities (Exhibits F-2 and F-3; Vogel 733, 625; Bock 135-36, 138; Opinion pp. 17, 19; 1302a, 1303a, 734a, 626a, 135-36a, 138a, 1458a, 1459a). Goldman, Sachs verifies an issuer's bank lines as part of its standard investigative procedure (Vogel 625, 733; 626a, 734a). Bank lines supporting 80 to 100% of outstanding commercial paper are "typical" of issuers handled by Goldman, Sachs and most of its two hundred issuers have 100% (Exhibit F-63; Lepley 976-77; Van Cleave 501-2; Tr. 1019; 1348a, 977-78a, 502-3a, 1021a).

13. On September 3, 1969 a Penn Central financial officer, Robert Loder, called Wilson concerning Penn Central's plan to seek Interstate Commerce Commission approval to increase its commercial paper outstandings from $150 million to $200 million (Exhibit F-22; Wilson 1144; 1311a, 1146a). As of that date Penn Central's commercial paper was supported by bank lines totalling $100 million (Lepley 983-88; Wilson 1102, 1150-51, 1153; Opinion p. 17; 984-89a, 1104a, 1152-53a, 1458a). During this conversation Wilson, stating that Goldman, Sachs had a lot of questions to ask about the merger, cash flow and Penn Central's long-term financing plans, made an appointment to meet with Jonathan O'Herron, Penn Central's financial vice president and other Penn Central financial officers (Exhibit F-22; Wilson 1144-45; 1311a, 1146-47a).

14. The meeting was held on September 11, 1969 (Vogel 666-67; Wilson 1146-47; Exhibit F-7; 667-8a, 1148-49a, 1307a). O'Herron pointed out to Wilson and Vogel that Penn Central would be in a "very tight" cash position in the first quarter of 1970 and requested that Goldman, Sachs "put out as much paper as possible" for maturity in April or later (Exhibit F-7; Wilson 1147-48; 1307a, 1149-50a). Wilson asked whether it would be possible for Penn Central to get an additional $50 million in bank lines; O'Herron replied that he would prefer not to do so (Exhibit F-7; Wilson 1150-53; Vogel 667-68; 1307a, 1152-55a, 668-69a).

15. Penn Central received the requisite ICC approval to increase its commercial paper outstandings from $150 million to $200 million on October 29, 1969 (Exhibit F-48; Opinion p. 15; 1457a). In its decision the ICC noted that, on the whole, Penn Central was in a "strong financial condition" (Exhibit F-48; Bock 169; Opinion p. 15; 169a, 1457a). However, the ICC's decision also contained the following observation:

"Applicant feels that long-term financing at the present time is not feasible due to the tight money situation. Although we are sympathetic to applicant's problem, short-term financing has traditionally been relied upon to finance short-term needs and is not normally regarded as a proper source for long-term financing of capital expenditures or for refinancing of maturing long-term debt. As of June 30, 1969, applicant had a deficit working capital situation which can be expected to worsen if reliance on short-term financing is increased. The exhaustion of short-term credit to refinance maturing long-term debt or to finance long-term capital expenditures could expose a carrier to a serious crisis in the event of an economic squeeze, at which time a carrier may require short-term financing for traditional use. We are, therefore, concerned about the use of short-term financing for long-term purposes and feel that where necessary it should be resorted to cautiously." (Exhibit F-48; Bock 168-69; 168-69a)

16. Goldman, Sachs received a copy of the ICC decision by letter dated November 6, 1970 (Exhibit F-50). Increasing Penn Central's commercial paper outstandings to $200 million reduced its bank line coverage to 50% (Wilson 1150-54; Stipulated facts par. 24; 1152-56a, 1452a).

17. On October 22, O'Herron had told Wilson that while the railroad would show a small loss for the 1969 third quarter, he anticipated that the fourth quarter would be "in the black" with a good improvement (Exhibit F-20; Wilson 1159; 1161a). Wilson suggested to O'Herron during a conversation on November 10 that Penn Central get an additional $50 million in bank line coverage (Exhibit F-17, Wilson 1154; 1309a, 1156a).

18. Another meeting of Goldman, Sachs' representatives and Penn Central's financial officers was held in New

York on December 9, 1969 (Exhibits F-9 and F-63, Lepley 916-17; 1308a, 1348a, 917-18a). The discussion was mainly about bank line coverage (Lepley 917; 918a). As Lepley testified, Goldman, Sachs wanted Penn Central to increase its bank line coverage from 50% to 100% (Lepley 919; 920a). Lepley made a number of inquiries as to the number of issuers who had 80% coverage (Lepley 977-78; 978-79a). He was told that 80 to 100% coverage was "typical" for Goldman, Sachs' issuers and that the majority had 100% (Exhibit F-63; Lepley 976-77; 1348a, 977-78a). Lepley left the meeting convinced that Penn Central, with only 50% coverage, was "sticking out like a sore thumb" as far as its bank line coverage was concerned (Lepley 977-79; Tr. 1019; 978-80a, 1021a).

19. After the December 9 meeting Lepley discussed with O'Herron, Loder and John H. Schaeffer, Penn Central's treasurer, whether they could get additional bank lines (Lepley 979-81; 980-82a). The consensus was that additional bank lines would be difficult to obtain because of the current tight money situation and because Penn Central was already very heavily indebted to a significant number of banks (Lepley 980-81; 981-82a). Indeed, Lepley concluded by the end of December 1969 that Penn Central had reached its borrowing limit with American domestic banks (Lepley 982, 1025; 983a, 1027a). Any possibility of obtaining Euro-dollar bank lines never materialized (Lepley 982-83; 983-84a). No additional bank line coverage was ever obtained (Lepley 982; Wilson 1194, 1205-6, 1213-14; Stipulated facts par. 24; Opinion pp. 17, 19; 983a, 1196a, 1207-8a, 1215-16a, 1452a, 1458a, 1459a).

20. By the end of 1969, Goldman, Sachs knew that substantial portions of Penn Central's assets had been pledged (Vogel 734-35; 735-36a). In fact, substantially all investments and properties in the Penn Central consolidated balance sheet and substantially all of the railroad's properties and investments were pledged as se-

curity for loans or otherwise restricted under indentures and loan agreements, a fact which Vogel learned in April 1970 after Franklin's purchase* (Vogel 737-39; 738-40a).

21. Penn Central's 1969 annual and fourth quarter earnings were announced on the broad tape of the New York Stock Exchange during Wednesday afternoon of February 4, 1970 and were carried in the press on the following day (Opinion p. 15; Wilson EBT 133; Tr. 126-27; Exhibit F-2; 1457a, 126-27a, 1302a). The loss for the year was \$56.3 million and the loss for the fourth quarter was \$16 million (Exhibit F-2; Wilson 1159-61; 1302a, 1161-63a). As stated in paragraph 17, *supra,* O'Herron had told Wilson on October 22 that the railroad's fourth quarter earnings would be "in the black" with a good improvement (Exhibit F-20; Wilson 1158-59; Tr. 125-27; 1310a, 1160-61a, 125-27a). The fourth quarter losses contradicted O'Herron's prediction; came as a complete surprise to Goldman, Sachs; and, as the District Court found, "shocked" Goldman, Sachs into immediate action (Opinion p. 15; Exhibits F-2 and F-3; Tr. 125-27; Wilson 1159-60, 1164-67; 1457a, 1302a, 1303a, 125-27a, 1161-62a, 1166-69a).

---

* The District Court stated at page 21 of its opinion that Mr. Bock "knew or should have known that a footnote to the 1969 financial statement pointed out that substantially all assets had been pledged as security for loans." (Opinion p. 21; 1459a). The court was referring to Note 7 of Peat, Marwick, Mitchell & Co.'s "Notes to Financial Statements" (Exhibit F-30; see also Defendants' Exhibit A-28 at pp. 4-9). The entire certification, including Note 7, was contained in the 1969 Annual Report (Defendants' Exhibits 8 and A-28; pre-trial order p. 7). However, this report, as confirmed by the date of Chairman Saunder's accompanying letter to stockholders would not have been distributed prior to March 16, 1970, the date of Franklin's purchase (Defendants' Exhibit A-20A, pp. 9-11). Thus, there is no evidence to support the quoted sentence (See Mr. Bock's testimony at pp. 164-165 and Mr. Vogel's at pp. 737-39; 164-65a, 738-40a).

22. During the night of February 4, Wilson, from his home, telephoned Goldman, Sachs' senior partner, Levy, then in St. Louis, to report the news of Penn Central's losses (Wilson 1164-65; Exhibit F-2; Opinion p. 15; 1166-67a, 1302a, 1457a). Wilson requested Levy to arrange a conference with Penn Central's chief financial officers—David Bevan, executive vice president and chairman of the finance committee, and O'Herron, financial vice president (Wilson 1165-67, 1195-6; Exhibit F-3; 1167-69a, 1197-98a, 1303a). The desired conference was held in New York on Friday, February 6 (Opinion p. 16; Wilson 1167, 1195-6; Exhibit F-3; 1458, 1169a, 1197-98a, 1303a).

23. Meanwhile, on Thursday, February 5, Wilson telephoned Hemphill, the partner in charge of Goldman, Sachs' Chicago office about "a game plan . . ." (Wilson 1099-1100; 1101-1102a). Wilson then telephoned O'Herron to discuss the bad news (Exhibit F-2; Wilson 1099-1100; Opinion p. 16; 1302a, 1101-02a, 1458a). Wilson told O'Herron that "it was unfortunate that we [Goldman, Sachs] did not have some indication of the magnitude of the total loss for 1969, as we are going to need a story to tell existing holders of Penn Central's paper and new purchasers of paper" (Opinion p. 16; Exhibit F-2; Tr. 125-27; 1458a, 1302a, 125-27a). Wilson asked O'Herron what Penn Central's cash picture looked like for the first six months of 1970 and was told that it was "very tight" (Exhibit F-2; 1302a). Wilson feared that there would be a "run-off" of Penn Central's commercial paper—i.e. loss of market acceptance—and told O'Herron that the "most important thing" that Penn Central could do would be to get another $100 million in bank lines to bring its coverage up to 100% (Exhibit F-2; Wilson 1102; 1302a, 1104a). O'Herron stated that he did not think that Penn Central could get $100 million in additional bank lines (Exhibit F-2; 1302a).

24. As of February 5, 1970 Goldman, Sachs was carrying about $15 million of Penn Central's commercial paper in its inventory (Exhibit F-55, p. 13; Exhibit F-2; Opinion p. 16; 1328a, 1302a, 1458a). On February 5, Wilson asked O'Herron if Penn Central would buy back Goldman, Sachs' inventory position out of the bank lines then available to it (Opinion p. 16; Exhibit F-2; Wilson 1187-88, 1204-06; 1458a, 1302a, 1189-90a, 1206-08a). O'Herron agreed to buy back two-thirds, or $10 million worth, on the following Monday, February 9 (Opinion p. 16; Exhibits F-2 and F-4; 1458a, 1302a, 1305a).

25. On February 5, Wilson also gave O'Herron notice that in the future Goldman, Sachs would switch to a "tap" issue sales procedure whereby Goldman, Sachs would not carry Penn Central's notes in inventory* (Exhibit F-2; Wilson 1101-02; 1302a, 1103-04a). "Tap" or special order paper entails no market risk for Goldman, Sachs (Doty 599-600; Bock 142-48; 600-01a, 142-48a). O'Herron responded by stating that this matter should be discussed at a higher level by Bevan and Levy (Exhibit F-2; Wilson 1101-02, 1183-85; 1302a, 1103-04a, 1185-87a). O'Herron's desire to go "over [Wilson's] head" (Wilson 1183-84; 1185-86a) was undoubtedly prompted by the fact that since Goldman, Sachs had been inventorying as much as $20 million of Penn Central's paper, implementation of a "tap" issue sales procedure would represent a loss of a substantial cash source to Penn Central when it was depending solely on "roll-overs" to meet commercial paper maturities (Exhibits F-55, pp. 11-13 and BI; Lepley 933-

* "Tap" issue or special order paper is held by a bank selected by the issuer (in Penn Central's case by Morgan Guaranty) pending delivery to a purchaser (Van Cleave 422-423; 423-24a). The paper is issued by the bank (Morgan) after Goldman, Sachs has found a purchaser, has notified Penn Central of the details of the sale, such as amount and maturity date, and the bank has received authorization from the issuer (Penn Central) (Van Cleave 472-76; 473-77a).

34; Opinion pp. 11, 17; 1326-28a, 1384-87a, 934-35a, 1456a, 1458a).

26. There were other developments on February 5 (Exhibits F-1, F-2, and F-3; Opinion pp. 12, 19-20; 1301-03a, 1456-57a, 1459a). Brown Brothers Harriman & Co., a respected investment banking firm with long experience in railroad financing, removed Penn Central from its approved list (Opinion pp. 19-20; Exhibits F-3 and F-4; Wilson 1171-77; Bock 151-58, 296; Tr. 317; 1459a, 1303a, 1305a, 1173-79a, 151-58a, 296a, 317a). Brown Brothers Harriman & Co. had previously purchased as much as 15% of Penn Central's commercial paper. Since Penn Central's outstandings as of February 5 were $200 million, Brown Brothers' action, like Goldman, Sachs' decision to stop inventorying Penn Central paper, represented a loss of a substantial cash source, in this instance $30 million (Wilson 1172-73, 1184-85; Opinion p. 19; 1174-75a, 1186-87a, 1459a). Without even knowing the firm's identity, Penn Central requested Wilson to set up an appointment with the firm to review the 1969 financial results (Wilson 1173; Exhibits F-3 and F-4; 1175a, 1303a, 1305a). Brown Brothers declined and the appointment could not be arranged, a fact which Wilson conveyed to O'Herron on February 12 (Exhibit F-4; 1305a).

27. On February 5, the late Allen Rogers of NCO called Vogel, expressed concern over the 1969 results and inquired whether Goldman, Sachs was going to continue to offer Penn Central's paper (Exhibit F-1; Vogel 682-86, 755; 1301a, 683-87a, 756a). Vogel told Rogers that Goldman, Sachs would continue to sell the company's paper despite the 1969 losses (Exhibit F-1; Vogel 684-85, 755; 1301a, 685-87a, 756a). Vogel stated that Penn Central had a number of valuable properties and securities, and that he was certain something could be "worked out" if it should ever become necessary (Exhibit F-1; Vogel 684-86, 755; 1301a, 685-87a, 756a). Rogers replied that "as a re-

sult of" Vogel's comments NCO would continue Penn Central's "Prime" rating (Exhibits F-1 and F-3; Vogel 684-86, 755; Opinion p. 12; 1301a, 1303a, 685-87a, 756a).

28. On February 6, Levy and Wilson had their scheduled luncheon conference with Bevan, O'Herron and Loder (Exhibit F-3; Wilson 1194-96; Opinion pp. 16-17, 19; 1303a, 1196-98a, 1458a, 1459a). During the course of this meeting Penn Central's financial officers, expanding on the information given by O'Herron on the previous day, disclosed that the railroad was budgeting for another $56 million loss for 1970 and that the railroad would require an additional $170 million cash in 1970 for capital improvements and equipment (Exhibits F-2 and F-3; Opinion pp. 16-17; 1302a, 1303a, 1458a). Bevan stated that the projected loss for the first quarter was $49 million and that the actual loss would probably be $6 or $7 million more (Bevan Deposition 58-59, Wilson 1114, 1209-10; 1440a, 1116a, 1211-12a).* The projected loss of $49 million for the first quarter of 1970 was three times the $16 million loss sustained for the fourth quarter of 1969 and was almost four times the $12.8 million loss in the first quarter of 1969 (Wilson 1169, 1213; Defendants' Ex. AZ, Defendants' post-trial memorandum, p. 99; 1171a, 1215a, 1383a).

29. During the February 6 meeting Levy and Wilson repeated the request Goldman, Sachs had been making for "some months", that Penn Central get $100 million in additional bank lines in order to increase its bank line coverage from 50% to 100% (Exhibit F-3; Wilson 1102, 1197-98; Opinion p. 17; 1303a, 1104a, 1199-1200a, 1458a). Levy and Wilson said that if such lines were not obtained

---

* Penn Central's actual first quarter loss was $62.7 million, approximateley $7 million more than Bevan's estimate on February 6 (Wilson 1211-14, Bevan Deposition 58-59; 1213-16a, 1440a).

the railroad's level of outstandings would run down to $100 to $150 million (Exhibit F-3; Wilson 1102, 1197-98, 1213-14; Opinion p. 17; 1303a, 1104a, 1199-1200a, 1215-16a, 1458a). Bevan and O'Herron, confirming the latter's statement of the previous day, responded that they did not feel they could get the additional bank lines (Exhibit F-3; Wilson 1197-98; Opinion p. 19; 1303a, 1199-1200a, 1458-59a). The Brown Brothers Harriman decision to remove Penn Central from its approved list and Vogel's conversation with NCO's Rogers were also discussed (Exhibit F-3; Levy 801-3; Wilson 1173-74; Opinion pp. 12, 19; 1303a, 802-04a, 1175-76a, 1456-59a). Finally, Levy and Wilson advised the Penn Central officers that a $5 million limit would be imposed on the amount of Penn Central commercial paper which Goldman, Sachs would carry in its inventory (Exhibit F-3; Van Cleave 504-09; Opinion p. 17; 1303a, 505-10a, 1458a).

30. Pursuant to the agreement between Wilson and O'Herron on February 5, Penn Central bought back $10 million of Goldman, Sachs' inventory on Monday, February 9, 1970 (Exhibits F-2 and F-4; Wilson 1185-86, 1190-91; 1302a, 1305a, 1187-88a, 1192-93a). The buy-back was financed by Penn Central's "precious existing insufficient" bank lines, reducing Goldman, Sachs' inventory to just below the $5 million level (Exhibits F-2, F-3, F-4 and F-55 p. 13; Wilson 1102, 1205-06; Opinion pp. 17, 19; 1302a, 1303a, 1305a, 1328a, 1104a, 1207-08a, 1458-59a). Only once before had Goldman, Sachs returned commercial paper to an issuer because it wished to reduce its own inventory of that issuer and placed a limit on the amount of paper it would inventory in the future* (Van Cleave 505-

---

* This occurred in 1969 when Goldman, Sachs requested the Avco companies to buy back a substantial portion of their commercial paper from Goldman, Sachs' inventory and placed a limit on the amount it would carry in the future (Defendants' Exhibit EV and EW; 1411-12a). As in the case of Penn Central, this action was taken after Goldman, Sachs had expressed concern about the company's affairs and its apparent lack of full bank line coverage (Exhibits EV, EW, F-2, F-3, F-4 and F-5; Tr. 15-16; 1411-12a, 1302a-06a, 15-16a).

14; Lynch Deposition 39-41; Defendants' Exhibits EV and EW; Opinion p. 18; 506-15a, 1411-12a, 1458a).

31. Under date of February 18, 1970, Goldman, Sachs prepared for distribution to its commercial paper customers a one page green sheet reporting, *inter alia,* the $56 million loss sustained by Penn Central for the year 1969 (Exhibit F-84A; Bock 103-05; cf. Opinion p. 20; 1355a, 103-05a, 1459a). This green sheet contained no mention of the following non-public information: the $56 million loss which Penn Central was budgeting for 1970; the especially severe loss which was being projected for the first quarter; the railroad's "very tight" cash position; its stated inability to obtain 100% bank line coverage; the Brown Brothers decision to remove Penn Central from its approved list; NCO's stated reason for continuing the Prime rating; or Goldman, Sachs' decisions and actions to reduce, restrict and ultimately eliminate its own inventory (Bock 133-58; Kaufman EBT 26-38; Levy EBT 111-12, 127-30, 140-42, 163-65, 168, 170-80; Exhibit F-84A; Opinion p. 20; 133-58a, 1355a, 1459a).

32. The green sheet of February 18 was mailed by Goldman, Sachs to Franklin in connection with a prior purchase of Penn Central commercial paper, not the subject of this action, on March 13, 1970 (Exhibits F-83 and F-84A; Van Cleave 480-82; Bock 103-05; 1351a, 1355a, 481-83a, 103-05a). Another copy of the green sheet may or may not have been included with the confirmation letter which Goldman, Sachs mailed to Franklin in connection with the March 16 purchase (Van Cleave 480-82; Bock 103-05, 116-18; 481-83a, 103-05a, 116-18a). In these and other communications, both oral and written, Goldman, Sachs did not disclose to Franklin the information referred to in the preceding paragraph (Opinion pp. 15-21, 1457-59a).

33. Goldman, Sachs' decisions to restrict and ultimately to eliminate its own inventory were still in effect on March 16 when Goldman, Sachs offered and sold a $500,000 Penn Central commercial note to Franklin (Exhibit F-5; Tr. 15-16; Van Cleave 422-23, 74; 1306a, 15-16a, 423-24a, 472-75a). Indeed, Goldman, Sachs' sale to Franklin on March 16 was a "tap" or a "special order" transaction (Van Cleave 422-23, 471-74; 423-24a, 472-75a).

34. On March 23, 1970, just one week after Franklin's purchase, Wilson told O'Herron that the $5 million inventory ceiling would continue until "such time as they [Penn Central] obtained 100% line coverage, completed some of these long-term financings and started to reduce the operating losses" (Exhibit F-5; Tr. 15-16; 1306a, 15-16a). The zero inventory objective was reached on April 8 (Exhibits F-2 and F-55, p. 14; Van Cleave 516; 1302a, 1329a, 517a). No Penn Central commercial paper was inventoried thereafter, and Goldman, Sachs held none on June 21 when the reorganization petition was filed (Exhibit F-55, pp. 13-15; Van Cleave 516: Opinion p. 19, 1328-30a, 517a, 1458-59a).

POINT I

Jurisdiction Exists Under the 1933 and 1934 Acts.

Appellants challenge jurisdiction under the 1933 Act on the ground that the sale to Franklin was not effected by the use of any means or instruments of transportation or communication in interstate commerce or of the mails. With respect to jurisdiction under the 1934 Act, appellants claim that the commercial paper note sold to Franklin was not a security. After close consideration, the District Court properly rejected both contentions (Opinion pp. 5-13, 14-19; 1455-59a). Indeed, the precedents and record facts provide a jurisdictional basis not recognized by the District Court.

A. The Securities Act of 1933

Section 12(2) imposes civil liability upon any person who offers or sells a security "by the use of any means or instruments of transportation or communication in interstate commerce or of the mails. . . ." 15 U.S.C.A. §771(2). The District Court concluded that either the mailing by Goldman, Sachs of a letter to Franklin dated March 16, 1970 confirming the sale or the additional mailings which occurred in normal course between Franklin and the Savings Banks Trust Company sufficed to confer jurisdiction (Opinion pp. 5-8; 1455a).

It is established law that the mailing of a letter confirming a prior sale constitutes sufficient use of the mails to sustain jurisdiction under the 1933 Act.

> *United States* v. *Cashin,* 281 F.2d 669 (2d Cir., 1960)
>
> *United States* v. *Monjar,* 147 F.2d 916, 920 (3d Cir. 1944), *cert.* denied 325 U.S. 859, and cases cited therein
>
> *United States* v. *Porter,* 441 F.2d 1204 (8th Cir. 1971)
>
> *Schillner* v. *H. Vaughan Clarke & Co.,* 134 F.2d 875, 877 (2d Cir. 1943)
>
> *United States* v. *Wolfson,* 405 F.2d 779 (2d Cir. 1968), *cert.* denied 394 U.S. 946 (1969)
>
> *Creswell-Keith, Inc.* v. *Willingham,* 264 F.2d 76 (8th Cir. 1959)
>
> *Welch Foods, Inc.* v. *Goldman, Sachs & Co.,* 398 F.Supp. 1393 (S.D.N.Y. 1974)

In *United States* v. *Cashin, supra,* cited by the District Court, the defendants challenged jurisdiction under §17(a) on the grounds (1) that the only alleged use of the mails was to confirm purchases already induced by the defendants' deceit and (2) that no claim was made that

the mailings alleged were necessary to the execution of the unlawful scheme. In rejecting both contentions, this Court stated at page 673:

> "The gist of the crimes charged in the indictment, as in most Securities Act cases, is the fraudulent scheme employed in the sale of securities. See *United States* v. *Robertson, D.C.S.D.N.Y.* 1959, 181 F.Supp. 158; *United States* v. *Monjar, supra.* The purpose of the requirement that there be a use of the mails or other facilities of commerce is solely to create a basis for federal jurisdiction. *Creswell-Keith, Inc.* v. *Willingham,* 8 Cir., 1959, 264 F.2d 76; *Schillner* v. *H. Vaughan Clarke & Co.,* 2 Cir. 1943, 134 F.2d 875; *United States* v. *Robertson, supra.* The use of the mails need not be central to the fraudulent scheme and may be entirely incidental to it. See, e.g., *Kopald-Quinn & Co.* v. *United States,* 5 Cir. 101 F.2d 628, certiorari denied sub nom. *Ricebaum* v. *United States,* 1939, 307 U.S. 628, 59 S.Ct. 835, 83 L.Ed. 1511."

Welch, like *Franklin,* involved the mailing of a confirmation letter and claims against Goldman, Sachs under both Acts. In sustaining jurisdiction under the 1933 Act, Judge Brieant concluded at page 1396:

> "Use of the mails 'to confirm purchases already induced by defendant's deceit' is adequate, and 'the mailing need not be central to the fraudulent scheme as it would be in a mail fraud case.' *United States* v. *Cashin,* 281 F.2d 669, 673-74 (2d Cir. 1960); see also *Jaffee & Co.* v. *SEC,* 446 F.2d 387, 392 (2d Cir. 1971)."
>
> * * *
>
> "Use of the mails as part of a sale, even though subsequent to it, appears to be sufficient to sustain jurisdiction."

Thus Judge Brieant, like Judge Metzner, found *Cashin* applicable. Judge Brieant also found that documents employed in prior sales, including Goldman, Sachs' green, white and yellow sheets, may be considered as documents by which a later sale was made. (*Welch, supra,* trial transcript pp. 3178-79).

It is also established that where the defendant causes his victim to use the mails in connection with the sale of a security, a claim will lie under Section 12(2).

> *Creswell-Keith, Inc.* v. *Willingham, supra*
> *Pereira* v. *United States,* 347 U.S. 1, 8-9 (1954)

Under the foregoing authorities there were not less than five mailings, each sufficient to support jurisdiction under the 1933 Act. They were:

1. The mailing by Goldman, Sachs of a letter to Franklin on March 16, 1970 confirming the sale (Ex. F-88; Bock 116-17, 123; Van Cleave 480; 1356a, 116-17a, 123a, 481a).

2. The mailing of a letter from Franklin to Savings Banks Trust Company on March 16, authorizing and directing Savings Banks Trust Company to receive from Goldman, Sachs a Penn Central Transportation Company note for $500,000, payable on June 26, 1970, and to charge Franklin's account in the sum of $487,958.33 (Exhibit F-88; Bock 115; 1356a, 115a).

3. The mailing of a letter from Savings Banks Trust Company to Franklin on March 16, 1970 confirming that the note had been received by its depository, Chemical Bank New York Trust Company, and was being held in its custody for Franklin (Exhibit F-88; Bock 115-16; 1356a, 115-16a).

4. A second letter from the Savings Banks Trust Company to Franklin dated March 16, 1970 confirming

that Franklin's account had been debited in the sum of $487,958.33 (Exhibit F-88; Bock 116-17; 1356a, 116-17a).

5. Goldman, Sachs' mailing of the February 18 green sheet to Franklin on March 13, 1970 in connection with another sale of Penn Central paper on that date (Exhibits F-84A and F-83; Van Cleave 480-82; Bock 117-18; 1355a, 1351a, 481-83a, 117-18a). Another copy of the February 18 green sheet may or may not have been included with the letter confirming the March 16 sale (Van Cleave 480-82; cf. Bock 118; 481-83a, .118a).

The record contains abundant proof of the importance of written confirmations to banking institutions and to the governmental agencies which regulate their affairs (Opinion pp. 7-8; Bock 115-16, 121-23; Lepley 936-37, 969-70, 1017; 1455a, 115-16a, 121-23a, 937-38a, 970-71a, 1019a). The confirmation letters which Savings Banks Trust Company mailed to Franklin represented the sole written evidence in Franklin's files that the Penn Central note had been received and was being held for Franklin's account (Bock 115-18; 115-18a). The financial information concerning the issuer which Goldman, Sachs enclosed with its confirmation letter is also important to banks and their regulatory agencies (Bock 103-08; Wilson 1129-30; Wilson-*Welch* 1806-08; Van Cleave 378-79; 103-08a, 1131-32a, 378-79a).

Goldman, Sachs was properly charged with knowledge that mailings between Franklin and Savings Banks Trust Company would follow in the ordinary course of business. See Van Cleave 548-49; Tr. 971-72; Bock 107-08, 115-18, 121-23; Wilson 1130-31; 549-50a, 972-73a, 107-08a, 115-18a, 121-23a, 1132-33a; Opinion p. 8; 1455a, citing *United States* v. *Wolfson, supra,* and III Loss, Securities Regulation, ch. 9F at 1521-28 and VI Loss, *supra,* ch. 9F at 3744-51. Goldman, Sachs' contention that these mailings were not foreseeable cannot be reconciled with its

own use of the mails in connection with the transaction: its mailing of a letter to Franklin confirming the sale (Ex. F-88; 1356a).

The District Court rejected appellee's contention that the intrastate telephone conversation on Monday morning, March 16, between Mr. Bock and Goldman's salesman, Mr. Kaufman, sustained jurisdiction under the 1933 Act* (Opinion p. 6; 1455a). However, the sale to Franklin was on a "special order" basis (Van Cleave 373; 373a). Therefore, after the Bock-Kaufman telephone conversation, Goldman, Sachs was obliged to telephone Penn Central in Philadelphia to advise it of the amount, rate and maturity date (Van Cleave 373-77, 473, 475-76, 479; Lepley 965-68; 373-77a, 474a, 476-78a, 480a, 966-69a). Penn Central was then obliged to telephone Morgan in New York to notify it of the transaction and to authorize and direct Morgan to complete, countersign and deliver the note (Exhibit F-89; Van Cleave 476; Lepley 969; 1361a, 477a, 970a). Finally, in accordance with established procedures, Penn Central mailed a letter to Morgan confirming these instructions (Lepley 969-70, 1017, 936-37; 970-71a, 1019a, 937-38a).

Appellee is mindful of Judge Brieant's statement at page 1396 of *Welch* that use of the mails and an interstate telephone call between Goldman, Sachs in New York and Penn Central in Philadelphia were too "remote" to constitute a jurisdictional basis as well as Judge Metzner's statement that Goldman, Sachs sold the note to Franklin as principal (Opinion p. 6; Van Cleave 501, 548; Wilson 1109; 1455a, 502a, 549a, 1111a). However, the foregoing interstate calls can scarcely be characterized as "remote", having occurred on March 16 *after* the Bock-Kaufman telephone conversation and *before* the note was completed, countersigned and delivered (Van Cleave 373-77;

---

* The decisions are conflicting. A list, both *pro* and *contra,* may be found in *Dupuy* v. *Dupuy,* 511 F.2d 641 at p. 643, n. 3 (5th Cir. 1975).

373-77a). Without these interstate telephone calls and Penn Central's written confirmation of Morgan's authority, the note would have been neither countersigned by Morgan nor presented to Goldman, Sachs for delivery to Franklin (Van Cleave 475-79; Lepley 936-37, 965-70, 971-72, 1015-17; cf. Bock 122-23; 476-80a, 937-38a, 966-71a, 972-73a, 1017-19a). Accordingly, appellee submits that these interstate telephone calls were also "an integral and essential part of the transaction . . . sufficient to support jurisdiction." *Welch Foods, Inc.* v. *Goldman, Sachs & Co., supra,* at 1396.

B. The Securities Exchange Act of 1934

Before the District Court the defendants conceded that *Zeller* v. *Bogue Electric Manufacturing Corp.*, 476 F.2d 795 (2d Cir. 1973), *cert.* denied 414 U.S. 908 was the controlling precedent in this Circuit (Defendants' post-trial memorandum on jurisdiction, p. 8). Under *Zeller* and the previous Seventh Circuit decision, *Sanders* v. *John Nuveen & Co.*, 463 F.2d 1075 (7th Cir. 1972) *cert.* denied 409 U.S. 1009, only commercial paper which satisfies all of the requirements of SEC Release No. 33-4412, 17 C.F.R. §231.4412 (1961) is exempt from the anti-fraud provisions of the 1934 Act. These requirements are that the paper be:

> ". . . (1) prime quality negotiable commercial paper, (2) of a type not ordinarily purchased by the general public, that is, (3) paper issued to facilitate well recognized types of current operational business requirements; and (4) of a type eligible for discounting by Federal Reserve banks." *Sanders* v. *John Nuveen & Co., Inc., supra* at 1079.

In *Welch, supra,* which involved Penn Central commercial paper notes bearing purchase dates before and after Franklin's, the court sustained jurisdiction under the 1934

Act on the ground that the commercial paper satisfied none of the foregoing requirements. Notwithstanding Franklin's argument that Goldman, Sachs is estopped from relitigating the identical issue* in *Franklin,* Judge Metzner viewed the question of subject matter jurisdiction under the 1934 Act independently of *Welch.*

Judge Metzner properly found that the note which Franklin purchased on March 16, 1970 did not satisfy the prime** quality standard. Penn Central's cash position for the first six months of 1970, a period encompassing the note's maturity date, was "very tight" (Exhibit F-2; Wilson 1178; 1302a, 1180a). Well before March 16, 1970

---

* See *Blonder-Tongue* v. *University of Illinois Foundation,* 402 U.S. 313, 323 (1970), citing with approval *Zdanok* v. *Glidden Co.,* 327 F.2d 944, 954-56 (2d Cir. 1964), *cert.* denied 377 U.S. 934 (1964); *Stoll* v. *Gottlieb,* 305 U.S. 165, 172, 177 (1938); *Hadge* v. *Second Federal Savings and Loan Ass'n of Boston,* 409 F.2d 1254, 1257 (1st Cir. 1969); *Ripperger* v. *A. C. Allyn & Co.,* 113 F.2d 332, 333 (2d Cir. 1940), *cert.* denied 311 U.S. 695; *Loucke* v. *United States,* 21 F.R.D. 305, 309-10 (S.D.N.Y. 1957); as to the identity of issues, see *Welch Foods, Inc.* v. *Goldman, Sachs & Co., supra* at p. 1403 ("The jurisdictional questions were pleaded as affirmative defenses in the answer in this and all actions. No formal pre-trial motion was made in this case, but in the related *Franklin* case . . . Goldman, Sachs did move orally before the assigned judge to dismiss on identical grounds, applicable here to Welch.") and *Goldman, Sachs & Co., et al.* v. *Hon. David N. Edelstein,* 494 F.2d 76 (2d Cir. 1974) at p. 77 ("Both cases [*Welch* and *Franklin*] raise identical claims based on substantially the same proof against Goldman, Sachs. . . .") (Matter in brackets added).

** The Court in *Welch* adopted a generic definition of the expression "prime": "first in value or excellence; of excellence; of excellent quality; first rate." *Welch, supra* at 1398. Mr. Bock considered prime quality to embrace such factors as earnings capacity, a genuine and good cash flow, sound management capable of fulfilling its projections and bank lines (Bock 110-11, 138-41, 162-65, 304; cf. Levy 829-32; Wilson 1088-89; 110-11a, 138-41a, 162-65a, 304a, 830-33a, 1090-91a).

the railroad was budgeting for a loss of $56 million in 1970 and was projecting a loss for the first quarter exceeding $49 million (Exhibits F-76, F-77, F-78; Bevan Deposition 58-59; Wilson 1114, 1209-10; Defendants' post-trial memorandum p. 99; 1440a, 1116a, 1211-12a). Moreover, substantially all of its properties and investments were pledged or otherwise restricted under indentures and loan agreements* (Exhibit F-80, n. 7; Vogel 734-39; Bock 163-65; cf. Bevan 116-21; Sullivan 856, 886-87; Exhibit F-70; 735-40a, 163-65a, 1443a, 857a, 887-88a). The issuer had exhausted its borrowing capacity with domestic banks (Lepley 980-83; cf. Bock 138, 165; 981-84a, 138a, 165a).

The majority of the commercial paper of some 200 companies then being sold by Goldman, Sachs was secured by 100% bank line coverage (Lepley 976-77; Exhibit F-63; Van Cleave 501-02; 977-78a, 1348a, 502-03a). Eighty percent coverage was typical (Exhibit F-63; Lepley 916-17, 976-77; 1348a, 917-18a, 977-78a). Penn Central's line coverage was only 50% (Lepley 977-79; Wilson 1194; 978-80a, 1196a). In early February 1970 Goldman, Sachs told Penn Central that it feared a run-off if 100% bank line coverage were not obtained (Exhibits F-2, F-3; Opinion p. 17; 1302a, 1303a, 1458a).

The run-off which Goldman, Sachs feared occurred in late April 1970 (Wilson 1213-14; 1215-16a). Banks extending $96.5 out of $100 million line coverage made good on their commitments when called upon at the end of April and in early May (Exhibit F-21; Sullivan 878-79, 892-93; Lepley 949-51, 984-88; Wilson 1153, 1213-14; 879-80a, 893-94a, 950-52a, 985-89a, 1155a, 1215-16a). From its own cash sources, the issuer could muster only $20 million —10% of its outstandings (Lepley 1001-03; Wilson 1213-14;

* Any assets which were unrestricted were not the type which could be readily converted to cash to meet commercial paper maturities (Bevan Deposition 116-21; Lepley 984-88, 1003; Wilson 1213-14; 1443a, 985-89a, 1004a, 1215-16a).

cf. Bevan Deposition 116-21; 1002-04a, 1215-16a, 1443a). Thus, approximately $85 million could not be paid and was outstanding when the railroad filed its reorganization petition on June 21, 1970 (Lepley 1003; Wilson 1214; 1004a, 1216a).

In addition to the foregoing financial facts, Goldman, Sachs' decisions and actions to reduce, restrict and ultimately eliminate its own inventory compels the conclusion that the sole dealer in Penn Central commercial paper did not believe it to be of prime quality (Opinion p. 19; 1458-59a). Under the topic "The Merits of the Litigation" the District Court discussed these and other facts which led it to find that Franklin's paper was not prime (Opinion pp. 13, 14-19; 1457-59a). These multiple facts will be discussed in Point II of this brief.

Notwithstanding such facts appellants, as they did before the District Court, suggest that the paper was prime quality because as of March 16, 1970 major banks were still accepting the paper for overnight loans and were still carrying Penn Central on their approved lists. Mr. Doty testified that it was hardly unique for Penn Central to be accepted as part of an overnight loan package and that during the period 1969 through April 1, 1970 he could only recall one company's paper being rejected (Doty 591-93; 592-94a). In addition, the banks had primary recourse to Goldman, Sachs and its capital of $45 million (Doty 566-67, 564; 567-68a, 565a). The fact that banks such as Manufacturers still carried the paper on approved lists was immaterial in the absence of proof that such banks had the same information concerning Penn Central's affairs as Goldman, Sachs had (cf. Sullivan 884-85; see also Exhibits F-2, F-3 and F-4; 885-86a, 1302-1305a).

Realizing the futility of contending that the Penn Central commercial paper sold to Franklin satisfied the four-ply test of SEC Release No. 33-4412 endorsed by *Zeller, supra,* the appellants assert that *Zeller* should be

overruled. There is no merit to this contention. In applying the four-ply test, *Zeller* followed the Seventh Circuit decision in *Sanders, supra.* Both decisions were based on the Supreme Court's admonition in *Tcherepnin* v. *Knight,* 389 U.S. 332 (1967), that the 1933 and 1934 Acts be read together. Although *Tcherepnin* did not focus on the exclusionary language of §3(a)(10) of the 1934 Act in holding that a share in a savings and loan institution was a "security", the Court cited Senate Report No. 792, 73rd Cong. 2nd Sess., 14 (1934) as a key indicator of the Congressional intent behind the 1934 Act. That report states that the definition of "security" is "substantially the same" in both the 1933 and 1934 Acts. Appellants argue that Judge Friendly improperly relied on this Senate Report for his conclusion that the four-ply test should be applied to the 1934 Act as well as the 1933 Act.

Aside from the fact that the Senate Report is not the only basis for Judge Friendly's conclusion, (see *Zeller, supra* at 800) appellants' argument that Senate Report No. 792 is an unreliable guide to the legislative intent behind the 1934 Act is untenable. This Senate Report is a major congressional explanation of the 1934 Act, despite the fact that Senate Bill 3420, which it accompanied, was not the ultimate enactment in every detail.

The only difference between Section 3(a)(3) of the 1933 Act and the exclusionary provisions of §3(a)(10) of the 1934 Act is the former's phrase referring to "current transactions". The original bills introduced in both the House and the Senate in February 1934 (S. 2693 and H.R. 7852) contained no exclusion at all for short term notes. Apparently recognizing the need to exclude some notes from the application of the Act, Congress drafted §3(a)(10) with exclusionary language identical to that contained in §3(a)(3) of the 1933 Act. (S. 3420 and H.R. 8720) However, the bill finally enacted by the House and Senate (H.R. 9323) omitted the "current transactions"

phrase from §3(a)(10). Since none of the reports or debates provides any explanation for the difference in wording, persuasive weight should be given Senate Report No. 792 as the Supreme Court did in *Tcherepnin* and as this Court did in *Zeller*. As stated in Note, "The Commercial Paper Market and the Securities Acts", 39 University of Chicago Law Review 362 (1972) at 400:

> "The construction of the exclusionary provision of section 3(a)(10) of the 1934 Act in terms of the legislative history of the section 3(a)(3) exemption of the 1933 Act is particularly proper in this instance because of the companion scope and aims of the two federal securities acts and because of the absence in the legislative history of an explanation for the exclusionary language of section 3(a)(10)."

There is another reason why *Zeller* should not be overruled. The appellants' argument that short-term commercial paper is not a security under the 1934 Act overlooks the prefatory language of the definition section (§3) of the 1934 Act:

> "When used in this title, unless the context otherwise requires—"

Emphasizing the "context" of the transaction and mindful of *Tcherepnin's* stress on "economic reality," 389 U.S. at 336, a long line of cases including *Zeller* has held that promissory notes which are purchased for investment purposes, such as the note Franklin purchased from Goldman, Sachs on March 16, 1970,* are "securities" within the meaning of the 1934 Act.

---

* Unquestionably the note which Franklin purchased from Goldman, Sachs on March 16 was a security investment. Franklin pur-

(Footnote continued on following page)

> *The Exchange National Bank of Chicago* v. *Touche Ross & Co.*, (Docket No. 75-7633) (2d Cir., decided June 9, 1976) and cases cited therein.

As stated in *Sanders, supra,* at 1080:

> ". . . when Congress spoke of notes with a maturity not exceeding nine months, it meant commercial paper, not investment securities. When a prospective borrower approaches a bank for a loan and gives his note in consideration for it, the bank has purchased commercial paper. But a person who seeks to invest his money and receives a note in return for it has not purchased commercial paper in the usual sense. He has purchased a security investment." (citations omitted)

In view of this long established and uniform interpretation of the 1934 Act, *Zeller* should not be overruled. To do so would "produce a seemingly irrational difference in the scope of their [the 1933 and 1934 Acts] anti-

---

(Footnote continued from preceding page)

chased the note on the open market through a "broker-dealer." Goldman, Sachs sold the note to Franklin as part of its regular market trading. Franklin's transaction is in no way analogous to the commercial loan transactions enumerated at page 4097 of *The Exchange National Bank of Chicago*:

> "the note delivered in consumer financing, the note secured by a mortgage on a home, the short-term note secured by a lien on a small business or some of its assets, the note evidencing a 'character' loan to a bank customer, short term notes secured by an assignment of accounts receivable or a note which simply formalizes an open-account debt incurred in the ordinary course of business. . . ."

Indeed, in its brief, Goldman, Sachs has consistently referred to purchasers of commercial paper as "investors" (pp. 4-6, 7-8) and to commercial paper itself as an "investment." (p. 5).

fraud provisions". *The Exchange National Bank of Chicago* v. *Touche Ross & Co., supra* at 4086. If the law is to be changed, the change should be made, as this Court has suggested, by Congress. See *The Exchange National Bank of Chicago* v. *Touche Ross & Co.,* at 4097.

POINT II

Liability lies under both the 1933 Act and the 1934 Act.

A. As to Both Acts

The District Court's findings concerning the material facts which Goldman, Sachs failed to disclose to Franklin are set forth at pages 14-21 of the opinion under the heading "The Merits of the Litigation". The District Court emphasized the following:

1. Penn Central sustained a loss of $16 million in the fourth quarter of 1969, a quarter which Penn Central's O'Herron had informed Goldman, Sachs would be "in the black" with a good improvement (Exhibits F-2 and F-20; Wilson 1158-61; Tr. 125-27; 1302a, 1310a, 1160-63a, 125-27a). This loss came as a complete surprise to Goldman, Sachs and, as the District Court found, "shocked" Goldman, Sachs into "immediate action". (Opinion p. 15; Exhibits F-2 and F-3; Tr. 125-27; Wilson 1159-60, 1164-67; 1457a, 1302a, 1303a, 125-27a, 1161-62a, 1165-69a).

2. The railroad was budgeting for a loss of $56 million for 1970 which, when added to the $170 million of additional necessary financing, resulted in a total cash requirement of $226 million for that year (Exhibit F-3; Opinion 16-17; 1303a, 1458a). According to O'Herron, the rail-

road's cash position for the first six months of 1970 would be "very tight". (Exhibit F-2; 1302a).

3. On February 5 and again on February 6, Goldman, Sachs repeated its previous requests that Penn Central obtain 100% bank line coverage for its outstanding commercial paper of $200 million (Exhibits F-2 and F-3; Wilson 1102; Opinion p. 16; 1302a, 1303a, 1103a, 1458a). Goldman, Sachs feared a run-off of $50 to $100 million if such coverage were not obtained (Exhibit F-3; Tr. 135; Opinion p. 17; 1303a, 135a, 1458a). Penn Central had only 50% bank line coverage as of February 5 and at no time thereafter did Penn Central increase its bank line coverage above 50% (Lepley 982; Opinion p. 17; 983a, 1458a).

4. Goldman, Sachs, which in the past had purchased as much as $20 million or 10% of Penn Central's outstandings for its own inventory, took the extraordinary steps on February 5-9 of (a) requesting Penn Central to buy back its entire inventory position of $15 million; (b) selling two-thirds of that amount back to Penn Central, the transaction being financed by the very bank lines which Goldman, Sachs considered insufficient; (c) placing a $5 million limit on the amount that it would inventory thereafter; and (d) giving Penn Central "notice" that in the near future it would sell the paper only under a "special order" or "tap" issue arrangement whereby Goldman, Sachs would not inventory any of the paper (Exhibits F-2, F-3, F-4 and F-5; Tr. 15-16; Opinion pp. 16-19; 1302-06a, 15-16a, 1457-59a).

5. On February 5, Brown Brothers Harriman & Co., which had previously purchased as much as 15% of Penn Central's total outstandings,

stopped buying Penn Central paper (Exhibits F-3 and F-4; Opinion pp. 19-20; 1303a, 1305a, 1459a). Brown Brothers' action, like Goldman, Sachs', meant that Penn Central had lost a sizeable source of cash at a time when it was depending solely on roll-overs to meet maturities (Opinion pp. 11, 19 and 20; 1456a, 1459a).

None of the foregoing facts was disclosed to Franklin. Each was a material fact because, as the court concluded, "a reasonable man would attach importance to it in determining his choice of action in the transaction. . . ."* (Opinion p. 22; 1459-60a). The materiality of the aforementioned omissions is self-evident when analyzed under three interrelated categories: (a) liquidity; (b) bank lines and (c) inventory decisions.

Liquidity

Since commercial paper notes are short term and are unsecured, the issuer's liquidity is very important (Levy 831; Bock 91-92; 832a, 91-92a). On February 5, 1970, O'Herron, expanding on a statement previously made in September, told Wilson that Penn Central's cash position for the first six months of 1970 would be "very tight" (Exhibits F-2 and F-7; 1302a, 1307a). This news was supplemented by additional information at the luncheon conference on February 6 when Penn Central's top financial officers told Levy and Wilson that the railroad's total cash requirements for the year would be $226 million, representing capital expenditures projected at $170 million and a budgeted loss for the entire year of $56 million

---

* The court followed the definition of materiality enunciated by this Court in *List* v. *Fashion Park, Inc.*, 340 F.2d 457, 462 (2d Cir. 1965) *cert.* denied 382 U.S. 811 (1965) and cited with approval in *TSC Industries, Inc.* v. *Northway, Inc.*, —— U.S. ——, 44 LW 4852, 4854 n. 8 (1976).

(Exhibits F-2 and F-3; Wilson 1195-97; Bock 138-42; Opinion pp. 15, 16-17; 1302a, 1303a, 1197-99a, 138-42a, 1457-58a). The first quarter loss would be especially severe (Wilson 1114, 1209-10; 1116a, 1211-12a). Bevan stated that the projected first quarter loss was $49 million but that the actual loss would be $6 million or $7 million more (Bevan Deposition 58-59; 1440a).

The projected loss of $49 million was three times the surprise $16 million loss sustained during the fourth quarter of 1969 and was almost four times the $12.9 million loss for the first quarter of 1969 (Wilson 1161; 1213a, 1163a, 1215a). Thus, as the District Court found, Penn Central's cash requirements exceeded those previously "envisioned by . . . knowledgeable persons" (Opinion p. 15; 1457a).

Bank Lines

Bank lines are important to commercial paper investors because they provide an alternative source of cash to meet commercial paper maturities (Bock 135-36, 138; Vogel 733; 135-36a, 734a). By February 1970, Goldman, Sachs had been trying for "some months" to persuade Penn Central to increase its bank line coverage from 50 to 100% (Wilson 1102; 1104a). On February 5, Wilson told O'Herron that the "most important thing" Penn Central could do would be to get an additional $100 million in bank lines (Exhibit F-2; Tr. 134; 1302a, 134a). The request was repeated by Levy and Wilson at the meeting of February 6 (Exhibit F-3; 1303a). Indeed, Goldman, Sachs told Bevan, O'Herron and Loder that unless Penn Central increased its coverage to 100% they thought the level of outstandings would drop by $50 to $100 million (Exhibit F-3; Opinion p. 17; 1303a, 1458a). Penn Central's top financial officers responded that they did not believe Penn Central could get additional bank lines (Exhibit F-3; 1303a). It never did (Stipulated facts par. 24; Tr. 136-37; 1452a, 136-37a).

Whether an issuer's paper is supported by 100% bank line coverage is an important factor in the marketability of its paper (Wilson 1088-89, 1151; 1090-91a, 1153a). Because Penn Central had only 50% coverage, Wilson feared that a run-off—i.e. loss of market acceptance—might occur for that reason alone (Exhibits F-2 and F-3; Wilson 1194; 1302a, 1303a, 1196a).

At trial the defendants tried to discount the importance of bank lines by insisting that they are "ephemeral" (Levy 828-30; see also Van Cleave 402-21, 426; 829-31a, 403-22a, 427a). This was not the case with regard to Penn Central's bank lines. As Bevan testified, Penn Central's bank lines were contractual, "confirmed lines" for which the railroad paid an interest charge (Bevan Deposition 51-52; 1438a). Thus, 72 out of 74 banks honored their commitments to Penn Central when called upon (Lepley 984-86; Exhibit F-21; Tr. 153-54, 292; 985-87a, 153-54a, 292a). They did so after the first quarter losses of $62.7 million had been published (Sullivan 878-79, 892-93; Lepley 949-51, 984-88; Wilson 1153, 1211-14; 879-80a, 893-94a, 950-52a, 985-89a, 1155a, 1213-16a).

The District Court properly emphasized Goldman, Sachs' opinion that Penn Central's bank lines were insufficient for the amount of paper outstanding. Penn Central's "very tight" cash position, huge projected losses and cash needs made 100% bank line coverage essential (See District Court's opinion pp. 15, 16-17 and 19; 1457a, 1458a, 1459a). Penn Central's inability to obtain that coverage, in the face of Goldman, Sachs' repeated requests that it do so, was information to which any reasonable investor would have attached importance (Opinion p. 22; Bock 134-38; 1459-60a, 134-38a).

Mr. Bock testified that if he had known that Goldman, Sachs wanted 100% bank line coverage and that Penn Central was unable to obtain it, he would have concluded that Goldman, Sachs was concerned about Penn Central's

financial stability and that the commercial banks were reluctant to extend credit to it (Bock 134-38a; cf. Lepley 980-83; 134-38a, 981-84a). Mr. Bock would not have bought Penn Central paper if this information had been disclosed (Bock 137; Opinion pp. 17 and 19; 137a, 1458a, 1459a).*

It should be emphasized at this point that Goldman, Sachs assumed a market risk with respect to all commercial paper carried in its inventory (Doty 599-600; 600-601a). Penn Central's failure to obtain 100% bank line coverage meant that in the event of the "run-off" which Wilson and Levy feared, Goldman, Sachs, whose inventory had ranged as high as $18 million in January 1970, would have to look to Penn Central for full payment of all notes it had been unable to sell to the investing public. In light of what Goldman, Sachs knew about Penn Central's affairs, this was hardly an encouraging prospect. Its reaction to this situation demonstrates the significance which Goldman, Sachs itself attached to Penn Central's lack of full line coverage and to the adverse information it possessed concerning Penn Central.

Inventory Decisions

On February 5, Wilson asked O'Herron to buy back Goldman, Sachs' entire inventory then amounting to $15,510,000 (Exhibit F-2; 1302a). O'Herron demurred but did agree to buy back $10 million on Monday, February 9 (Exhibit F-2; 1302a). Wilson told O'Herron that in the

---

* Bock's testimony that bank lines *per se* were not a "cardinal yardstick out of all the others" did not obscure his testimony on these points (Bock 273; Opinion p. 21; 273a, 1459a). Indeed, subequent trial testimony by defendants' witness, Lepley, that he had concluded by late December 1969 that the railroad had exhausted its credit with domestic banks confirmed the validity of the inference Bock would have drawn, had such information been disclosed to him (Lepley 980-84; Opinion p. 19; 981-85a, 1459a).

future Goldman, Sachs would handle Penn Central's paper only on a "tap" issue basis whereby Goldman, Sachs would not inventory any of its notes (Exhibit F-2; 1302a). On the following day, February 6, Penn Central was told that in the meantime a $5 million ceiling would be imposed (Exhibit F-3; 1303a). The $10 million buy-back occurred, as scheduled, on February 9 (Exhibit F-4; 1305a).

Goldman, Sachs' actions with respect to its own inventory are material in themselves. *Chasins* v. *Smith, Barney & Co.,* 438 F.2d 1167 (2d Cir. 1970). In *Chasins,* the seller's failure to disclose its function as a market maker was held an omission sufficient to impose liability. The rationale was that the seller could have been motivated by considerations other than the intrinsic desirability of the security and that disclosure of its market-making role would have permitted the purchaser to question the reasons for the recommendation. *Franklin's* facts are even more compelling than *Chasins'*.

As conceded during summation and as Levy testified, by offering Penn Central commercial paper to prospective investors Goldman, Sachs was recommending that paper for purchase (Levy EBT 225-26; Tr. 1283; 1285a). However, when it recommended Penn Central commercial paper to Franklin on March 16, 1970, Goldman, Sachs had already reduced and restricted its inventory and was in the process of eliminating its own market position. In *Chasins* the seller failed to disclose its market-making role. In *Franklin* the seller was getting out of the market! (Cf. Bock 142-48; Doty 599-600; Opinion p. 19; 142-48a, 600-01a, 1459a).

In addition to being material in themselves, Goldman, Sachs' inventory decisions and actions confirm the materiality of the inside information which it possessed concerning Penn Central's cash position and requirements, earnings projections and bank line coverage. As stated

in *Securities and Exchange Commission* v. *Shapiro,* 349 F.Supp. 46, 54 (S.D.N.Y. 1972), aff'd 494 F.2d 1301:

> "Finally, and most convincingly, defendants' own conduct illustrates the materiality of the information. A major factor in determining whether events are material is the importance attached to them by those who knew about them. *Securities and Exch. Comm'n* v. *Texas Gulf Co.,* supra, 401 F.2d at 851. Here, the record reveals very significant juxtapositions between the timing of defendants' purchases and critical events in the negotiations . . .
>
> Defendants claim that their purchases were based on an evaluation of criteria independent of the merger negotiations. We reject that claim since the timing of the purchases clearly suggests that they were based on knowledge of the proposed merger and of the effect it would have on the value of Harvey's stock. Even though other factors may have been evaluated, their inside knowledge must be considered the key and motivating element in their decisions to buy."

See also *S.E.C.* v. *Texas Gulf Sulphur Co.,* 401 F.2d 833, 851 (2d Cir. 1968), *cert.* denied *sub nom. Coates* v. *S.E.C.,* 394 U.S. 976 (1969).

There can be no doubt that the $10 million buy-back, the imposition of a $5 million limit and the decision to cease inventorying Penn Central paper were extraordinary decisions:

1. They were made at the highest level by Levy, Wilson and perhaps Hemphill; Van Cleave, the number two man in the commercial paper department was not even consulted (Van Cleave 502-15; Wilson 1100, Exhibits F-2 and F-3; 503-16a, 1102a, 1302a, 1303a).

2. With respect to the $5 million limit, Van Cleave testified before trial that he could not recall a limit having been imposed on any other issuer (Van Cleave 506-09; 507-10a). Neither could Levy (Levy EBT 127-28). Similarly, Goldman, Sachs' commercial paper buyer, Mr. Lynch, testified that he had never been told to stop buying the commercial paper of any other issuer and that Penn Central was the only issuer on which he had been given a specific inventory limit (Lynch EBT 39-41). Lynch got these instructions from Wilson (Lynch EBT 39-40).

3. Ordinarily, 8% to 10% of an issuer's outstandings is not considered an excessive sum to carry in inventory (Exhibit F-55; Lynch EBT 21; 1316a). Since Penn Central's outstandings were $200 million, the $5 million limit represented a ceiling of 2½%.

4. With respect to the $10 million buy-back, Van Cleave testified before trial that he could not recall any other instance in which Goldman, Sachs returned paper to an issuer because it desired to reduce the inventory of that issuer (Van Cleave 506, 512-14; 507a, 513-15a).*

The obvious reason for their extraordinary inventory decisions was, as the District Court found, the defendants'

---

* The testimony which Wilson gave in November 1975 in the *University Hill* case (Appellants' brief p. 32-33), should be contrasted with his pre-trial testimony on April 14, 1972 that he could not recall any other instance where Goldman, Sachs sold back commercial paper to an issuer for the purpose of reducing Goldman, Sachs' own inventory (Wilson EBT 621-22).

desire to reduce their market exposure* (Beck 142-48; Doty 599-600; Opinion p. 19; 142-48a, 600-01a, 1459a). Wilson's blue sheet summarizing his conversation with O'Herron on March 23 alone compels this conclusion:

> "Regarding the amount of Penn Central Transportation's c/p GS & Co. was prepared to inventory at any one time, his recollection of the February 6th luncheon was that no decision had been reached and that both the \$5MM and \$10MM figures were still under consideration. I told him that it was not my understanding and that, in fact, GS & Co. felt that a \$5MM ceiling was appropriate until such time as they obtained 100% line coverage, completed some of these long-term financings, and started to reduce the operating losses." (Exhibit F-5, Tr. 15-16; 1306a, 15-16a).

Following this conversation with O'Herron on March 23, Goldman, Sachs did permit some small increases above the \$5 million ceiling during March 30-April 3 (Exhibit F-55 p. 14; 1329a). However, there was never any change in Goldman, Sachs' ultimate objective to eliminate entirely its inventory position (Exhibit F-2; 1302a). The zero goal was reached on April 8, some two weeks before the first quarter losses were published (Exhibit F-55 pp. 14-16; Wilson 1210-14; 1329-31a, 1212-16a). Thus, Goldman,

---

* On February 4 Goldman, Sachs' inventory was \$16,610.000 (Exhibit F-55 p. 13; 1328a). The inventory level had ranged even higher during December and January (Exhibit F-55 pp. 12-13; 1327-28a). The \$10,000,000 buy-back on February 9 reduced the inventory to \$4,650,000 (Exhibit F-55 p. 13; 1328a). Thereafter, through March 16, it consistently remained at levels below \$5,000,000 (Exhibit F-55, pp. 13-14; 1328-29a). There were only two exceptions; February 13 when the inventory reached \$6,050,000 and March 2 when Van Cleave, acting "on his own", permitted an increase to \$9,000,000 because only \$250,000 would be maturing on the following day and he expected no difficulty in reducing it on that date (Lepley 994-96; 995-97a).

Sachs, possessing adverse information about Penn Central, reduced its inventory position, while Franklin, not possessing this information, increased its position.

It is significant that Franklin had previously purchased a $1 million Penn Central commercial paper note on March 13 (Exhibit F-83; Van Cleave 481-82; 1351a, 482-83a). As Exhibit F-82, the summary of Franklin's commercial paper purchases from 1968-70, confirms, Franklin's purchases were generally in the $.5 to $1 million range and seldom did Franklin hold more than $1.5 million of commercial paper of any one issuer (Exhibit F-82). Certainly, a reasonably prudent investor operating within such an investment range and already holding $1 million of Penn Central commercial paper would have attached importance to the fact that the dealer offering him an additional half-million dollar investment had substantially reduced and was in the process of eliminating entirely its own market position (Opinion pp. 19-20; 1459a; see Mr. Bock's testimony at pp. 147-48; 147-48a).

In an attempt to explain their inventory decisions, appellants stress Exhibit F-56, the 1970 report on the Commercial Paper Department (Appellants' brief, pp. 8-9; Opinion p. 18; 1458a). However, there was vigorous opposition to this report within the firm and, as Levy conceded at trial, no portion of the report had been adopted as of the filing of the reorganization petition on June 21 (Levy 835-37; Doty 594-98; 836-38a, 595-99a).

Appellants also emphasize the cost of carrying inventory, particularly during high interest periods (Appellants' brief, pp. 9-10; Opinion p. 18; 1458a). Appellants' extensive argument cannot obscure the fact that their blue sheets, Exhibits F-2, F-3, F-4 and F-5, contain no reference to such costs or such phrases as "negative inventory carry" (1302a, 1303a, 1305a, 1306a). Certainly, these factors were not among the reasons cited by Wilson for the $5 million limit in his talk with O'Herron on March 23 (Exhibit F-5; Tr. 15-16; 1306a, 15-16a). Moreover, when

Levy was asked on direct examination to give his reasons for imposition of the limitation he failed to mention "negative inventory carry"; he had to be reminded of it (Levy 799-800; 800-01a).

As they did before the District Court in their Rule 59 motion, the appellants draw attention to other instances of commercial paper buy-backs. Only two have been documented. Both were called to the court's attention during the trial. The first involved a finance company, Avco Delta, and the second, Penn Central itself. Neither detracts from the extraordinary nature of the $10 million buy-back, the $5 million ceiling and the abandonment of inventory in favor of a "tap" issue sales procedure, all taken with respect to Penn Central.

The Avco Delta blue sheets (Defendants' Exhibits EV and EW; 1411a, 1412a), produced long after completion of pre-trial discovery (Pre-trial order p. 119), apparently represent the only other instance where Goldman, Sachs required an issuer to buy back a substantial portion of its inventory and placed a limit on the amount it would inventory in the future. As in the case of Penn Central, Goldman, Sachs took this action because of concern about the company's affairs and its apparent lack of full bank line coverage (Exhibits EV, EW, F-2, F-3, F-4 and F-5; 1411a, 1412a, 1302-06a).

The $16 million Penn Central buy-back of December 23, 1969 cannot be compared with the $10 million buy-back of February 9. The buy-back of December 23 was strictly a temporary measure, a point which Lepley impressed upon Goldman, Sachs when he consented to the transaction (Lepley 932-34, 990-94; 933-35a, 991-95a).

The defendants' "explanations" with respect to their inventory decisions were properly rejected for what they are: transparent afterthoughts (Exhibits F-2, F-3, F-4 and F-5; Tr. 15-16; Opinion pp. 18-19; 1302-06a, 15-16a, 1458-59a). However, even assuming that "negative inventory

carry" may have been evaluated, it was Goldman, Sachs' "inside knowledge which must be considered the key and motivating element in their decisions. . . ." *S.E.C.* v. *Shapiro, supra* at page 54.

B. The 1933 Act

Appellants contend that they made no statements, express or implied, which were rendered misleading by any omissions. Appellants also argue that liability should not be imposed under the 1933 Act because "mere silence" is not actionable. These contentions were properly rejected by the District Court (Opinion pp. 22-23; 1459-60a).

There is no dispute that during a telephone conversation on March 16, Goldman, Sachs offered the Penn Central commercial paper at issue to Mr. Bock—clearly an oral communication within the plain language of Section 12(2) (Bock 120-21; Opinion pp. 4-5; 120-21a, 1454a). The District Court found that when this sale was made Goldman, Sachs was holding out the paper as creditworthy and high quality (Opinion p. 22; see Statement of Facts, *supra*, pars. 2 and 7 and sources cited therein; 1459a). In offering the paper, Goldman, Sachs was concededly recommending the paper for purchase (Tr. 1283; Levy EBT 225-26; 1285a). Because this recommendation was made without disclosure of the "whole truth", any alleged opinion as to the creditworthiness of the paper is immaterial.

> *Hughes* v. *S.E.C.*, 174 F.2d 969, 975-76 (D.C. Cir. 1949)
>
> *Hanly* v. *Securities and Exchange Commission*, 415 F.2d 589, 597 (2d Cir. 1969)
>
> *Slade* v. *Shearson, Hammill & Co.*, (S.D.N.Y. 72 Civ. 4779, January 2, 1974)

As stated in *Slade, supra* at page 6:

> ". . . anyone in possession of material inside information must either disclose it to the investing pub-

lic, or, if he is disabled from disclosing it in order to protect a corporate confidence, or he chooses not to do so, must abstain from trading in *or recommending* the securities concerned while such inside information remains undisclosed. *Id.* at 848 (emphasis added)" (emphasis in text)

To permit the appellants to take refuge in any "opinion" or, as suggested at page 45 of their brief, "mere silence" would, under all the "surrounding circumstances" of this case (Opinion p. 19; 1458a), emasculate the "disclose or abstain" doctrine firmly established in this Circuit.

Securities and Exchange Commission v. *Texas Gulf Sulphur Co., supra,* at p. 848
Radiation Dynamics, Inc. v. *Goldmuntz,* 464 F.2d 876, 887 (2d Cir. 1972)
Shapiro v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.,* 495 F.2d 228 (2d Cir. 1974)
Slade v. *Shearson, Hammill & Co., supra*

The "mere silence" argument also ignores the Supreme Court's statement in *Affiliated Ute Citizens of Utah* v. *United States,* 406 U.S. 128, 151 (1972) that the "fundamental purpose" of the securities laws, including the 1933 Act, is "to substitute a philosophy of full disclosure for the philosophy of *caveat emptor. . . .*" The suggestion that the defendants could "stand mute" was specifically rejected at page 153. A similar contention was rejected in *Barthe* v. *Rizzo,* 384 F.Supp. 1063, 1068 (S.D.N.Y. 1974).

There is nothing peculiar to the commercial paper securities market which would justify an exception to the appellants' recognized duty of full disclosure (Opinion p. 20; 1459a). Goldman, Sachs had an established routine —the so-called green sheets—for the dissemination of current financial information to its customers (*id.*). This information was customarily enclosed with confirmation letters or distributed in advance to commercial paper pur-

chasers (Van Cleave 372; Defendants' post-trial memorandum pp. 58-59; 372a). The governing criteria included materiality and disclosure (Opinion p. 20; Vogel 719-20; 1459a, 720-21a). The February 18 green sheet mailed to Franklin gave no "inkling of the course of conduct pursued by Goldman, Sachs in relation to Penn Central's commercial paper" (Opinion p. 20; 1459a).

Moreover, disclosure could readily have been made during the telephone conversations in which the securities were offered and accepted. This fact was the subject of special comment by Judge Brieant during the *Welch* trial at page 3135:

> "The Court: Most of the facts, perhaps all of them, which he (Mr. Pollack) relies on as omitted facts are so simple that really you know, they could have been given. Maybe we are addressing this problem with hindsight and perhaps we shouldn't. But most of the facts could have been compressed into one half a sentence. The sentence could have been 'We think these are prime quality and just as good as anything else we have in our house but you ought to know such-and-such a fact.'" (matter in parenthesis added)

Even two to three minutes, Van Cleave's estimate of the length of the typical telephone conversation between commercial paper salesmen and investors, would be ample time to disclose Penn Central's very tight cash position, the projection of continued operating losses, its failure to comply with Goldman, Sachs' request for increased bank line coverage and Goldman, Sachs' inventory decisions (Van Cleave 392; Vogel 731-33; 392a). See for example, Wilson's succinct summary of the reasons behind the $5 million inventory limitation in his telephone conversation with O'Herron on March 23 (Exhibit F-5; Tr. 15-16; 1306a, 15-16a).

Mr. Bock or any other prudent investor would not have required any lengthy discourse before deciding to ask the salesman for another name. As of March 1970, some 60 to 75 other names were available (Van Cleave 502; 503a). See *Feit* v. *Leasco Data Processing Equipment Corp.*, 332 F.Supp. 544, 571 (E.D.N.Y. 1971).

C. The 1934 Act

As this Court stated in *Cohen* v. *Franchard Corp.*, 478 F.2d 115, 123 (2d Cir. 1973), the scienter requirement under Section 10(b) is met when it is established that the defendants "knew the material facts that were misstated or omitted and should have realized their significance . . ." Appellants concededly knew of material facts which they failed to disclose to Franklin. That appellants appreciated the significance of these facts is demonstrated by:

1. The "game plan" which Wilson discussed with Hemphill on the morning of February 5 (Wilson 1099-1100; 1101-02a);
2. The "story" which Wilson told O'Herron Goldman, Sachs would need to "tell existing holders of Penn Central's paper and new purchasers of paper" (Opinion p. 16; 1458a);
3. The misleading green sheet prepared by Goldman, Sachs under date of February 18, 1970 containing favorable information about Penn Central but omitting the adverse non-public information which Goldman, Sachs had learned on February 5-6 (Opinion p. 20; 1459a);
4. Goldman, Sachs' request that Penn Central buy back its entire inventory (Opinion p. 16; 1458a);
5. Goldman, Sachs' decision to lighten its load and reduce its exposure by selling back two-thirds of its inventory to Penn Central on February 9

and setting a $5 million limit pending change-over to a "tap" or "special order" sales procedure (Opinion pp. 16, 19; Exhibits F-2 and F-3; 1458a, 1459a, 1302a, 1303a);

6. Goldman, Sachs' knowledge that Penn Central would be forced to resort to its "precious existing insufficient lines of credit" to finance the $10 million buy-back (Opinion p. 19; 1459a);

7. Goldman, Sachs' reduction of its inventory to zero by April 8, 1970, some two weeks before publication of the first quarter earnings which Goldman, Sachs knew would be poor (Bevan Deposition pp. 58-59; Wilson 1114, 1209-10; Exhibit F-55, p. 14; 1440a, 1116a, 1211-12a, 1329a);

8. Goldman, Sachs' recommendation of the paper to Franklin when it no longer had "faith" in the paper (Opinion p. 19; Tr. 1283; Levy EBT 225-26; 1459a, 1285a).

Under these circumstances, the sale to Franklin was a deception satisfying the scienter requirement long recognized by this Circuit, *Heit* v. *Weitzen*, 402 F.2d 909 (2d Cir. 1968); *Shemtob* v. *Shearson, Hammill & Co.*, 448 F.2d 442, 445 (2d Cir. 1973), and recently recognized by the Supreme Court in *Ernst & Ernst* v. *Hochfelder*, 96 S.Ct. 1375 (1976).* In light of the explicit findings enumerated

---

* A recent case analogous on its facts is *Lanza* v. *Drexel & Co.*, [1970-71 Transfer Binder] CCH Fed. Sec. L. Rep. ¶92,826 (S.D. N.Y. 1970) 90,089, 90,102; aff'd as to other defendants 479 F.2d 1277 (2d Cir. 1973), wherein a defendant, having covertly taken steps to reduce his financial exposure in the company whose stock was purchased by the plaintiff, was held liable under Section 10(b). Appellants can derive no comfort from *Ernst* which adopted this Circuit's position that scienter is not met when a defendant *negligently* fails to discover and disclose material facts. *Ernst* did not address the question whether reckless behavior is sufficient for liability. Recklessness is immaterial in *Franklin* in view of the defendants' deliberate and deceptive conduct.

above, the fact that Judge Metzner did not use "the magic words 'intent to defraud'" is immaterial. *Globus* v. *Low Research Service Inc.*, 418 F.2d 1276, 1291 (2d Cir. 1969) *cert.* denied 397 U.S. 913 (1970).

D. Appellants' Evidentiary Points

As they did before the District Court in their post-decision motion, appellants contend that the result of the trial would have been different if the court had received further proof with regard to Brown Brothers Harriman's removal of Penn Central paper from its approved list on February 5, 1970; the handling of the Annenberg trust; and a block trade of Penn Central stock on May 27, 1970, some two months after Franklin's purchase. [Defendants also called attention to other buy-back transactions. These matters have been dealt with at pages 39-44, *supra*]. The District Court did not err in rejecting these contentions.

Appellants argue that Brown Brothers' action would have appeared insignificant if additional evidence had been offered and received showing that other firms add and delete names from their "approved lists" for reasons unrelated to creditworthiness. Van Cleave and Wilson did give testimony on direct examination about arbitrary standards employed by some commercial paper investors (Van Cleave 452-53; Wilson 1088-89; 453-54a, 1090-91a). Moreover, apart from its timing, Brown Brothers' removal of Penn Central paper from its approved list—for whatever reason—was significant because it represented the loss of a substantial source of cash for Penn Central (Opinion pp. 19-20; Exhibits F-3 and F-4; Wilson 1172-73; Tr. 1275-76; 1459-60a, 1303a, 1305a, 1174-75a, 1277-78a). When coupled with Goldman, Sachs' decisions of February 5-6 to reduce, limit and ultimately eliminate its own inventory, which had previously ranged as high as $20 million (Opinion p. 17; 1458a), the potential cash loss was as much as $50 million (Wilson 1172-73, 1184-85; 1174-75a, 1186-87a).

Certainly the significance of the actions taken by both Brown Brothers and Goldman, Sachs was appreciated by Penn Central. Penn Central requested a meeting with Brown Brothers (without even knowing the firm's identity) to persuade it to reconsider (Wilson 1173-74; Exhibits F-3 and F-4; 1175-76a, 1303a, 1305a) and requested that Goldman, Sachs reconsider, at the highest level, the proposed tap issue sales procedure (Wilson 1183-85; Exhibit F-2; 1185-87a, 1302a). Nor was the significance of these developments lost on Goldman, Sachs, which fully documented them in their blue sheets (Exhibits F-2, F-3 and F-4; 1302a, 1303a, 1305a). Appellants do not challenge the District Court's conclusion that if the actions taken by Goldman, Sachs and Brown Brothers had been disclosed, the run-off which Goldman, Sachs admittedly feared would have occurred much earlier than it actually did (Opinion pp. 19-20; Bock 142-48, 151-59; 1459a, 142-48a, 151-59a).

Similarly, there is no merit to appellants' contention concerning bank lines of credit (Point IV, p. 43). The additional evidence which the appellants would offer—Brown Brothers' making good on its $2 million share of Penn Central's commercial paper bank line coverage—was in fact received. See Exhibit BY and Lepley at 949-50; 1392a, 950-51a. The inference which appellants would have the Court draw is that Brown Brothers regarded Penn Central as creditworthy (Appellants' brief pp. 41-43). However, as Bevan testified, Penn Central's bank lines were contractual, "confirmed lines". (Bevan 51-52; 1438a). Exhibit F-21, a Goldman, Sachs memorandum of August 7, 1968, shows that Brown Brothers' line was intended to stand until 1973. In honoring its commitment on or about April 30, 1970, Brown Brothers was simply keeping its word (Lepley 949-51, 984-88; Bock 153-54, 158, 299; 950-52a, 985-89a, 153-54a, 158a, 299a). It was not alone in doing so; by May 11, 1970, 72 out of 74 banks had "honored" similar commitments (Lepley 950-51, 984-88; 951-52a, 985-89a).

The response of all these banks cannot be equated with their being satisfied with the railroad's financial condition or the quality of its commercial paper. The run-off (which commenced with the publication of the first quarter losses on April 23) had already begun and was in full swing when these banks were called upon (Lepley 949-51, 984-90, 999-1003; Wilson 1153, 1211-14; 950-52a, 985-90a, 1000-04a, 1155a, 1213-16a). Like Brown Brothers, these banks were keeping their word. Obviously, they were no longer buying Penn Central commercial paper for themselves or their customers (Lepley 999-1001; 1000-02a).

Although appellants claim otherwise, this $2 million share, which Brown Brothers had in the $100 million bank lines supporting 50% of Penn Central's commercial paper, was brought to Mr. Bock's attention on both direct and cross-examination and had no effect on his testimony (Bock 153-55, 158, 292-93, 293-300; Exhibit F-21; 153-55a, 158a, 292-93a, 293-300a).

During the course of their direct examination of Mr. Levy, the defendants attempted to elicit testimony and introduce documents concerning the handling of Mr. Annenberg's common stock in the railroad's parent company and Goldman, Sachs' purchase of a block trading position in such common stock on May 27, 1970, some two months after Franklin's purchase on March 16 (Levy 806-13; 807-14a). There was no error in the exclusion of this evidence since: (1) evidence pertaining to a different type of security at an unrelated point in time could scarcely be more peripheral, and (2) throughout the trial the defendants consistently objected to post-March 16 evidence, even to the extent of opposing reception of the reorganization petition itself. See, for example, Tr. pp. 20-21, 22-23, 320, 321-22 and 811-12; 20-21a, 22-23a, 320a, 321-22a, 812-13a.

CONCLUSION

The District Court's decision should be affirme..

Dated: New York, New York
September 1, 1976

Respectfully submitted,

Thacher, Proffitt & Wood
Attorneys for Plaintiff-Appellee

Robert S. Stitt,
George W. Taliaferro, Jr.,
Raymond L. Vandenberg,
Of Counsel.

3 COPY RECEIVED

SEP 1 1976

SULLIVAN & CROMWELL
ATTORNEYS FOR Goldman Sachs